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The Liability of Supervisory Board Directors in Germany**

The subject of this article is corporate governance—a key issue of the discussion concerning corporate law in the United States and in Europe. Indeed, the topic appears to be as old as the corporation itself. The following remarks focus on a singular, but nevertheless multifaceted, aspect of corporate responsibility: the liability of directors of a company.

Directors' liability has gradually been extended during recent years. The main reasons for this development are: the introduction of special legislation, the German Stock Corporation Act, prescribing objective liability, and a stricter assessment by the courts of what constitutes improper conduct. It must be acknowledged from an American viewpoint, however, that because there are no class actions in Germany, only a few cases concerning directors' liability are ever taken to court, as compared with frequent such litigation in the United States.

The growing attention of the public should also be noted. Market failures, corporate scandals, and cases of improper activities of directors have been disclosed. In particular, various data have been gathered in Germany about the relevance of multiple directorates, the influence of banks as members on supervisory boards, and the economic concentration of corporations. Remarkable examples are dealt with in public discussion. One such example is the takeover of the electronic and electrical parts producing company AEG by the car manufacturer Daimler-Benz. The influence of German banks is clearly illustrated by the proposed acquisition of the Flick conglomerate by the Deutsche Bank.[1] Past concerns about directors' conflicts of interest have now become even more acute.

Another facet that needs to be mentioned at the outset is the established and far-reaching system of labor codetermination on the supervisory board in Ger-

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1. *See, e.g.*, Frankfurter Allgemeine, Dec. 3, 1985, No. 280, at 13, concerning the takeover of AEG by Daimler Benz; *see also id.*, Dec. 7, 1985, No. 284, at 14, concerning the proposed acquisition of the Flick-conglomerate by the Deutsche Bank.

many. Workers' representatives serve alongside shareholders' representatives as directors on boards of various large enterprises. This arrangement helps to appease traditional ideological conflicts between capital and labor.

Furthermore, the refinements concerning the requirements of the directors' duties of care and loyalty are a constant challenge for judges and legal scholars. The discussion in this article concentrates on directors' standards of care, conflicts of interest, and fiduciary duties. The analysis attempts to define a basis of directors' duties and the prerequisites of their liability.

I. Background

A. Meaning of the Term "Director" in the Perspective of the Two Prototypes of Business Corporations and the Two-Tier System

The American use of the term "director" refers to a group of persons governing a private law corporation. Thus, director has a specific legal meaning within the corporate structure. In German legal language, the word director rarely appears and does not have the same distinct meaning. It is used often as a title for an individual having executive functions. To obtain a German equivalent, one must consider the structure of German corporations; in order to determine directors' potential liability under German law, their position within the organization of these corporations must be defined.[2]

There are two types of business corporations of overriding significance under German law: (1) the *Aktiengesellschaft* (AG), a public stock corporation or joint

2. The structure of German corporations has been carefully analyzed in a number of articles. Only the leading ones are cited: A. Conard, Corporations in Perspective (1976) [hereinafter A. Conard, Corporations]; M. Eisenberg, The Structure of the Corporation: A Legal Analysis (1976); Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 Mich. L. Rev. 1459 (1984) [hereinafter Conard, *Supervision*]; Eckert, *Shareholder and Management: A Comparative View on Some Corporate Problems in the United States and Germany*, 46 Iowa L. Rev. 12 (1960); Grossfeld, *Management and Control of Marketable Share Companies*, in 13 Int'l Enc. Comp. L. ch. 4 (1973) [hereinafter Grossfeld, *Management*]; Grossfeld & Ebke, *Controlling the Modern Corporation: A Comparative View of Corporate Power in the United States and Europe*, 26 Am. J. Comp. L. 397 (1978) [hereinafter Grossfeld & Ebke, *Controlling Corporate Power*]; Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 Mich. L. Rev. 1338 (1984); Roth, *Supervision of Corporate Management: The "Outside" Director and the German Experience*, 51 N.C.L. Rev. 1369 (1973); Schoenbaum & Lieser, *Reform of the Structure of the American Corporation: The "Two-Tier" Board Model*, 62 Ky. L.J. 91 (1973); Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 Harv. L. Rev. 23 (1966); most recently, *see* Behrens, *The Acquisition of Control over a Corporation Report on German Law*, German Nat'l Rep. (Private L. & Civ. Proc.) (1987); Raiser, *The Theory of Enterprise Law in the Federal Republic of Germany*, 36 Am. J. Comp. L. 111 (1988); Teubner, *Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person*, 36 Am. J. Comp. L. 130 (1988). Only some fundamental German legal literature is listed: A. Baumbach, A. Hueck & G. Hueck, Aktiengesetz § 76 note 7 (13th ed. 1968) [hereinafter A. Baumbach]; Meyer & Landrut, Aktiengesetz, Schilling, § 16 note 1 (1973) [hereinafter Schilling]; K. Schmidt, Gesellschaftsrecht (Company Law) (3d ed. 1986); *see further* Grossfeld & Ebke, *Probleme der Unternehmensverfassung in rechtshistorischer und rechtsvergleichender Sicht*, 22 Die Aktiengesellschaft [AG] 57–65, 92–102 (1977) [hereinafter Grossfeld & Ebke, *Problems*].

stock corporation; the governing body of law is the Stock Corporation Act of 1965 *Aktiengesetz* (AktG);[3] and (2) the *Gesellschaft mit beschrankter Haftung* (GmbH), a company with limited liability, or close corporation; the governing body of law is the Close Corporation Act of 1892 (GmbHG), as amended by the revised version of 1980, which became effective in 1981.

In accord with the AktG, the AG functions by means of a dual system of corporate government, a so-called two-tier system, under which corporate powers are shared by two entirely separate bodies: the *Vorstand,* or board of managers or executive directors, and the *Aufsichtsrat,* or supervisory board.[4] The shareholders' meeting (*Gesellschafterversammlung*) is the third independent body of the AG in which the shareholders exercise their rights concerning the corporation. During recent years, several countries have contemplated the supervisory board, which is separate and distinct from day-to-day management (i.e. the executive managers). The AktG rests upon the two-tier-system. The supervisory board is composed of persons who have their main duties elsewhere and are, therefore, only able to make a contribution to the operation of the company on a limited scale. It is for that reason that the supervisory board directors are sometimes referred to as "part-time directors." With regard to directors' liability, this factual restriction of time contributed must always be taken into account.

All functions and tasks of the executive management are allocated to the management board by section 76. Generally speaking, one may say that the management board fulfills the functions of the "in-house directors" or officers of a U.S. stock corporation, whereas the members of the supervisory board, who are elected by the shareholders' meeting, can somehow be compared with "outside directors" of a U.S. stock corporation. The supervisory board (the term is self-explanatory) supervises and controls the management board (section 111). According to the recent report of the German Corporate Law Commission, the two-tier system will be preserved. The Commission had considered a new model based on American corporate structure, but later rejected it.[5]

In a GmbH the functions of management are carried out by the *Geschäftsführung* or business management. Its legally required mandatory bodies are the

3. Aktiengesetz [AktG], 6 September 1965, Bundesgesetzblatt, Teil I [BGB1.I] 1089; *see* Behrens, *supra* note 2, at 10–12.

4. *See* H.J. MERTENS, *Annotations,* in KÖLNER KOMMENTAR § 76 note 1, (1970); MEYER LANDRUT, *supra* note 2, § 73 note 2; M. LUTTER, INFORMATION UND VERTRAULICHKEIT IM AUFSICHTSRAT 2 (2d ed. 1984); ECKHARDT, E. GESSLER, W. HEFERMEHL, & KROPFF, AKTIENGESETZ vor § 76 note 9 (1973) [hereinafter ECKHARDT]; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 399; Schwark, *Zum Haftungsmassstab der Aufsichtsratmitglieder einer Aktiengesellschaft,* in FESTSCHRIFT FÜR WINFRIED WERNER 841, 852 (W. Hadding ed. 1984) (publication in honour of Winfried Werner); Vagts, *supra* note 2, at 50; Conard, *Supervision, supra* note 2, at 1461, 1465.

5. Claussen, *Fussnoten zum Bericht der Unternehmensrechtskommission,* 28 AG 1, 7 (1983). A lot of large American corporations have "adopted working structures strikingly similar to the two-tier system," M. EISENBERG, *supra* note 2, at 180; for further reference, see Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 406.

shareholders' meeting *Gesellschafterversammlung*, in the sense of the supreme governing body of the corporation, and the business managers *Geschäftsführer*. The GmbH does not ordinarily have a mandatory supervisory board. However, its bylaws frequently provide for a corporate body in addition to the *Geschäftsführung*, which is entrusted with tasks similar, if not identical, to those of a supervisory board.[6] Terms and functions of supervisory boards in the GmbH are defined in section 52 of the GmbHG, which refers to various provisions of the AktG.

The American corporate law's "board of directors" performs functions carried out by two different bodies in the German corporation. Under German law the question of liability of directors, therefore, should concern itself with both the members of the executive management and with the members of the supervisory board. Under the two-tier system, the liability of executive managers and board members is treated as one common problem. The bipartition of a company's management is particularly distinct and of consequence in German law. Nevertheless, according to sections 116 and 93, the provision of the AktG on liability of directors of the supervisory board simply refers to the provisions of the business management.

B. Focus on the Directors of the Supervisory Board

In order to limit discussion, this article deals only with the directors of the supervisory board. Accordingly, there is no emphasis on the business managers. The scope of the discussion is limited to the liability of the directors of the supervisory board, both for the AG and the GmbH. The terms "directors" or "board members" are used to mean directors of a supervisory board. This distinction may not be easily compared to the American board system. Nevertheless, as this article shows, the difference in liability of the executive managers on the one hand and the directors of the supervisory board on the other results from the nature of their respective duties, rather than from a different concept of liability. The principles of the former are to a large extent applicable to the latter. That is why section 116, concerning directors' liability, simply refers to section 93, which sets out business managers' liability.

II. Functions of the Supervisory Board

In order to determine the impact and scope of liability, one should examine the legal functions of the supervisory board. These functions represent directors' duties. If the directors violate these duties in a negligent or willful manner, they expose themselves to liability under sections 116 and 93.

Section 116 is the basic provision for directors' liability. With regard to their duties, their standards of care, and their responsibility, this norm expressly refers

6. *See* M. Lutter, *supra* note 4, at 232.

to the business managers' legal basis of liability as laid down in section 93. According to section 116, in conjunction with section 93, subsection 1, the director's standard of care is that of a diligent and prudent businessperson. The members are jointly and severally liable to the company for a breach of their duties. Section 93, subsection 3, spells out specific breaches of legal duties, focusing mainly on the maintenance of share capital.

A. Supervision of the Management

The main function of the supervisory board of an AG is to supervise the management (section 111, subsection 1) by means of the control and inspection of the managers' actions.[7] The management has the right and the obligation to run the corporation, and the supervisory board may not interfere. The business managers lead the company independently.[8] The directors may not take over certain tasks of the management. The law expresses a clear distinction between managers and directors. According to section 105, subsection 1, directors may not at the same time be, or act as, managers and vice versa. The supervision of the management includes the inspection of their dealings in terms of legality, economy, and utility.[9] Due to the broadness of this scheme one can easily sense the conflict: if the directors over emphasize control of the management, they might interfere with the legal status of management and the manager's legal duty to run the company independently. If, however, the directors inspect the executive board too leniently, the directors are exposed to liability.

In order to implement its supervisory duties, the board may, among other things, inspect and supervise the books, records, and assets of the corporation.[10] The directors may call shareholders' meetings, (section 111, subsection 3) and approve certain transactions contemplated by the managers if the bylaws create

7. Judgment of Dec. 21, 1979, Bundesgerichtshof, BGH, 33 NJW 1629 (1980); Hoffmann, Der Aufsichtsrat note 100 (2d ed. 1985); Behrens, *supra* note 2, at 12; Conard, *Supervision, supra* note 2, at 1465; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 400; Hommelhoff, *Zur Kreditüberwachung im Aufsichtsrat,* in Festschrift für Winfried Werner, *supra* note 4, at 315, 318, 321; H.J. Mertens, *supra* note 4, § 93 note 33; Schilling, *Die Uberwachungsaufgabe des Aufsichtsrats,* 26 AG 341 (1981); Schwark, *supra* note 4, at 841, 852; Semler, *Aufgaben und Funktionen des aktienrechtlichen Aufsichtsrats in der Unternehmenskrise,* 28 AG 141, 148 (1983); *see* Vagts, *supra* note 2, at 50.

8. AktG § 76(1). The basic principle has recently been reiterated by the Austrian Supreme Court in its judgment of May 31, 1977, 28 AG, 81, 82 (1983). *See also,* Eckhardt, *supra* note 4, § 84 note 23; Hoffmann, *supra* note 7; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 400, 406; Hommelhoff, *supra* note 7, at 315, 318; Semler, *supra* note 7, at 83; Vagts, *supra* note 2, at 50.

9. *See* Vagts, *supra* note 2, at 50; Eckhardt, *supra* note 4, § 111 note 25; H.J. Mertens, *supra* note 4, vor § 95 note 2; Meyer & Landrut, *supra* note 2, § 111 note 3; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 400; Schilling, *supra* note 7, at 341–42; Semler, *supra* note 7, at 141–42.

10. AktG § 111(2); for detail, see M. Lutter, *supra* note 4, at 86; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 400; Vagts, *supra* note 2, at 51.

such right of prior approval (section 111, subsection 4). Other typical functions and tasks of the board of directors empower them to appoint and dismiss the managers (section 84),[11] to represent the corporation vis-à-vis managers (section 112),[12] and to receive regular reports by management on all facets of the company's business and request additional reports (section 940).[13] Moreover, the board may present proposals to the shareholders' meeting,[14] submit suggestions to the shareholders' meeting or to the court concerning the appointment of auditors,[15] examine and report in writing to the shareholders on the yearly financial statements,[16] and approve the yearly financial statements.[17]

This list is by no means exclusive. It reveals the board's far-reaching power. Since its power is not at all restricted to legal issues, it may challenge any aspect relating to the corporation.[18] One must bear in mind that the duty to supervise the managers is all-encompassing; it represents an integral part of German corporate governance. The voluntary supervisory board of a GmbH often has many of the same rights and duties as the board of an AG, clearly distinct from those of the managers. Thus, the concept of control of an AG and a GmbH can be summarized as follows: with respect to the management of the corporation, the supervisory board assumes a significant role in the decision-making process; only issues resulting in a fundamental change in corporate structure require action of the shareholders' meeting.

B. Supervisory Board's Ability to Form Committees

Realizing the variety of legal tasks resting on the directors, the question arises whether they can delegate functions to committees. Section 107, subsection 3, sentence 1, grants the power to the supervisory board to establish one or more committees. The directors may transfer various matters to personnel, finance, and planning committees. Accordingly, the directors may appoint certain board members as committee members. The freedom of the directors to form committees and to appoint members, as part of their right to organize their own affairs,

11. Hoffmann, *supra* note 7, No. 103 & No. 200; M. Lutter, *supra* note 4, at 4; Conard, *Supervision, supra* note 2, at 1465; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 400; Vagts, *supra* note 2, at 52.

12. Hoffmann, *supra* note 7, No. 228; Vagts, *supra* note 2, at 52.

13. Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 400; Vagts, *supra* note 2, at 51; *see also* Semler, *supra* note 7, at 141, 148 (special emphasis on the crisis of an enterprise); for detail, see Hoffmann, *supra* note 7, No. 246; M. Lutter, *supra* note 4, at 2.

14. AktG § 124(3); M. Lutter, *supra* note 4, at 21; Hoffmann, *supra* note 7, No. 318.

15. AktG § 124(3); Handelsgesetzbuch [HGB] § 318(3) & (4) Reichsgesetzblatt [RGB1.] 219 (German Commercial Code).

16. AktG § 171; Vagts, *supra* note 2, at 51.

17. AktG § 171(3); Hoffmann, *supra* note 7, No. 307; Schilling, *supra* note 7, at 341, 343.

18. For further details of the German system, see A. Conard, Corporations, *supra* note 2, at 81–84; M. Eisenberg, *supra* note 2, at 177–85; Eckert, *supra* note 2, at 27; Grossfeld, *Management, supra* note 2, § 5, at 607; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 406; Roth, *supra* note 2, *passim;* Schoenbaum & Lieser, *supra* note 2, at 91.

has recently been stressed by the German Supreme Court for Civil Matters in various cases.[19]

In addition, directors have the right to ask for external experts' advice on certain matters, in particular, when examining the company's books and records.[20] The German Supreme Court for Civil Matters has ruled in the famous *Hertie* decision that a supervisory board member has no grounds on which to have the company's books and records inspected by an expert on a broad and general basis.[21] In that case a director claimed to have generally inspected the company's business statements with the assistance of an external auditor. The judges underlined the basic principle that directors cannot delegate their functions to other persons; only with regard to specific questions may they ask for external experts' advice, which can only be decided on a case-by-case basis.[22]

The law prescribes that certain material functions cannot be shifted to committees or external experts. Section 107, subsection 3, sentence 2, expressly lists various tasks that are mandatorily reserved to the board of directors. Among those tasks are appointing or dismissing the management, calling shareholders' meetings, and examining annual financial statements of the company for approval. In addition, the directors, as a whole, must conduct a general inspection of the management, review the regular reports by the management, and select and inspect the committees and their members.[23] These remarks lead to the conclusion that directors may not delegate their legal functions on an indiscriminate basis; the German Supreme Court for Civil Matters has confirmed this notion.[24]

III. Codetermination by Workers and the Influence on the Supervisory Board

German labor codetermination has broadened the scope of the directors' responsibility. Various forms of labor (workers) codetermination have been introduced to the German legal system. The generally accepted catchword for such

19. Judgment of Feb. 25, 1982, Bundesgerichtshof, BGH, 83 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFS IN ZIVILSACHEN [BGHZ] 144, 148–49 (the Dynamit Nobel case); Judgment of Feb. 25, 1982, BGH, 83 BGHZ 106, 118, 119 (the Siemens case); HOFFMANN, *supra* note 7, No. 147; M. LUTTER, *supra* note 4, at 110; Hommelhoff, *supra* note 7, at 315, 324; Schwark, *supra* note 4 at 841.

20. AktG §§ 109(1), 111(2); Grossfeld & Ebke, *Controlling Corporate Power*, *supra* note 2, at 400.

21. Judgment of Nov. 15, 1982, Bundesgerichtshof, BGH, 85 BGHZ 293 (the Hertie case).

22. AktG § 111(5); Judgment of Nov. 15, 1982, Bundesgerichtshof, BGH, 85 BGHZ 293, 296, 297, 300.

23. A. BAUMBACH, *supra* note 2, § 107 note 13; HANAU & ULMER, CODETERMINATION ACT (MITBESTIMMUNGSGESETZ), §§ 120, 130 (1981); HOFFMANN, *supra* note 7, No. 147; M. LUTTER, *supra* note 4, at 110; MEYER & LANDRUT, *supra* note 2, § 116 note 4; Hommelhoff, *supra* note 7, at 315, 324; Schwark, *supra* note 4, at 841, 846; Semler, *supra* note 7, at 81, 83.

24. Judgment of Nov. 15, 1982, Bundesgerichtshof, BGH, 85 BGHZ 293, 300 (the Hertie case); *see* the earlier Judgment of June 5, 1975, BGH 64 BGHZ 325, 331, 332 (the Bayer case); *see also* M. LUTTER, *supra* note 4, at 135, 176.

actions is "industrial democracy." The supervisory board serves as the platform for labor influence. *De lege lata* and *de lege ferenda* labor codetermination takes place only on the supervisory board level. According to a recent report of the German Corporate Law Commission, there shall be no labor codetermination in the shareholders' meeting or in the business management.[25] If certain prerequisites are fulfilled, as shown below, companies are compelled to form a supervisory board with a mandatory quorum being composed of labor delegates. In particular, various close corporations with a specified number in the work force are legally bound to form a supervisory board.[26] Because of the growing number of mandatory supervisory boards, the issue of directors' liability now attracts attention. In order to point out the influence of labor codetermination on the supervisory board, a short overview concerning the relevant codetermination acts is necessary. Special stress is placed on the Codetermination Act of 1976.

A. Various Forms of Codetermination, Aside From the Codetermination Act of 1976

In the early 1950s, different systems of codetermination were established for the coal-mining, iron, and steel-producing industries, with a strengthened parity system in the supervisory board. In addition, according to the Labor Management Relations Act (the Act) of 1952 and 1972, codetermination was set up for AGs and larger GmbHs with a one-third labor participation in the supervisory board. Sections 76 and 77 of the 1952 Act, which are still binding law, apply to companies in the form of an AG or to partnerships limited by shares (*Kommanditgesellschaft auf Aktien*), which by reason of their corporate organization have to form a mandatorily required supervisory board. Furthermore, the Act applies to GmbHs employing more than 500, but fewer than 2,001, employees.

B. Codetermination Act of 1976

The new Codetermination Act[27] was published on May 4, 1976, and entered into force on July 1, 1976. After a transitional period of about two years, the law has now become fully effective.

The Codetermination Act was challenged on a constitutional basis. However, the German Constitutional Court upheld the Codetermination Act in its

25. Claussen, *supra* note 5, at 7; for further details on Codetermination, see Conard, *Supervision, supra* note 2, at 1483; Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 427–31; Grossfeld & Ebke, *Problems, supra* note 2, at 99 n.190 (with reference to several authorities); Hopt, *supra* note 2, at 1343; Raiser, *supra* note 2, at 114–21; Teubner, *supra* note 2, at 151; Vagts, *supra* note 2, at 65–79.

26. M. Lutter, *supra* note 4, at 232 (refers to the various Acts).

27. Gesetz über die Mitbestimmung der Arbeitnehmer (Codetermination Act), W. Ger., of 5 May 1976, BGB1.I 1189 (1976).

landmark-decision on March 1, 1979.[28] Therefore, the Codetermination Act of 1976 forms an integral part of the German legal system. The court pointed out that, under the Codetermination Act, the shareholders still retained a slight edge in voting power on the supervisory board. The Codetermination Act has a significant impact on corporate law and, in particular, on the large AGs and the GmbHs.

The basic requirements for the application of the Codetermination Act are that the companies are organized as corporations, or like corporations, and the company or the group of companies employ more than 2,000 people (section 1, subsection 1 of the Codetermination Act). The most significant facet of the new law is a strengthening of the labor unions. To appreciate fully the scope of the law one must again look at the German two-tier system. The influence of labor has an effect on the supervisory board. Generally speaking, labor forms half of this body. Thus, labor mainly affects the selection of the management. Furthermore, labor can try to block decisions of the management.

Codetermination, within the relevant form of legal organization, is accomplished through the composition of the supervisory board. Depending on the number of employees, the supervisory board will consist of twelve, sixteen, or twenty members, half of whom will be representatives from the labor side. Along with the representatives of the employees, there are, depending on the size of the supervisory board, two or three labor union representatives (section 7 of the Codetermination Act).

The chairman is the key player or quarterback of the supervisory board. In case of a tie vote on board resolutions, the chairman has a casting vote (section 29, subsection 2 of the Codetermination Act).

Among the members of the executive management, one member will be the so-called *Arbeitsdirector* or works director (section 33 of the Codetermination Act). This works director's responsibilities are linked to company personnel matters.

C. The Appointment of the Business Management by the Supervisory Board

Under the new Codetermination Act, the board's procedure for appointing the business management differs substantially from the procedure for an ordinary resolution. Section 31 of the Codetermination Act states that sections 84 and 85 of the AktG apply. This change is significant, especially for the GmbH, which is subject to the new law. According to the GmbHG, the sovereign body of GmbH is the shareholders' meeting, which in the past either appointed the managers itself or delegated this power to an administrative or supervisory board (sections 45, 46 No. 5 of the GmbHG). Now, mandatorily, for every enterprise subject to

28. Judgment of Mar. 1, 1979, Bundesverfassungsgericht, (BVerfG), 50 BVerfGE 290 (1979), 32 NJW 699 (1979).

the new law, the codetermined supervisory board is the only body empowered and entitled to appoint the managers. Sections 25 and 31 of the Codetermination Act supersede contrary GmbHG provisions.

The chairman's role as key player of the supervisory board is stressed in another situation. If the required majority for appointing the business management cannot be attained, the chairman has a casting vote in a new ballot (section 32, subsection 4 of the Codetermination Act). Of equal importance is that, according to section 84, subsection 1 of the AktG, the appointment of managers may not be made for a period exceeding five years. What was envisaged as a means of corporate protection (the AG and its many shareholders were supposed to be protected from managers who after a time proved to be inefficient) now turns into a device that gives even more control to the codetermined body and codetermination as such. The managers who stand for reappointment by the supervisory board are more dependent on this body than if their appointment was for an indefinite period. A substantial part of corporate governance is shifted to the supervisory board.

Appointment generally means a corporate act whereby the managers become members of the managing body, the business management. It does not mean the employment contract. German law makes a sharp distinction between these two acts. In the case of a GmbH, coming under the Codetermination Act, it has been severely disputed whether the power to enter into an employment contract with the business managers is also vested to the supervisory board or whether this power still belongs to the shareholders' meeting according to the concept of the GmbHG.

Several lawsuits have resulted. Among others, the *Reemtsma* case was brought to the German Supreme Court for Civil Matters. In that case the labor representatives of the supervisory board challenged the company's bylaws that granted the power of the conclusion of business managers' employment contracts entirely to the shareholders' meeting. The judges held that because of the close connection between the appointment and the conclusion of employment contracts of business managers, both functions belonged to the supervisory board's sphere of powers and duties.[29]

D. Shareholders' Dominance Prescribed by German Law and Corporate Bylaws

Apart from the AG with a supervisory board as a legal prerequisite, the Codetermination Act has a special impact on the GmbH with more than 2,000 employees. Such large GmbHs must also have a supervisory board. The board's mandatory powers, as granted by law, must be recognized and obeyed. According to sections 25 and 31 of the Codetermination Act and sections 84, 85 and 111

29. Judgment of Nov. 14, 1983, Bundesgerichtshof, BGH, 89 BGHZ 48, 54 (the Reemtsma case).

of the AktG, the supervisory board appoints and dismisses the business managers, is responsible for their employment contracts, and has other substantial rights and duties as shown above. It should be noted that for a GmbH coming under the Codetermination Act, the shareholders' meeting is the dominant governing body of the company. The shareholders' meeting remains empowered either to give management immediate directives or to decide management measures itself, which then need only be carried out by the management (as written down in sections 37, subsection 1, 45, subsection 1, 46, No. 5 of the GmbHG). Consequently, the bylaws may contain a catalogue of business matters that need the shareholders' approval. In case of conflict, the shareholders prevail as long as the supervisory board's previously mentioned mandatory rights and its autonomy as such are safeguarded. The German Supreme Court for Civil Matters has taken this viewpoint in recent decisions.[30]

Furthermore, the chairman of the supervisory board serves to maintain the shareholders' dominance in terms of corporate governance. As pointed out, his casting vote can overcome deadlock situations. Pursuant to the complicated procedure of section 27 of the Codetermination Act, the shareholders elect the chairman, who is supposed to act as their "long arm" on the supervisory board.

E. Consequences and Issues Resulting from "Industrial Democracy"

The "industrial democracy" of the Codetermination Act has established mandatory supervisory boards, with limited liability, in various large companies. Furthermore, the directors are also recruited from the work force and the unions. An issue remains as to whether labor codetermination really changes the distribution of power and influence within the corporation. Certain consequences related to the directors' remuneration, provided for by section 113, can be drawn; one notices a decrease, or at least a reduced increase, of the remuneration in a number of companies.

However, critical issues remain unsolved. Labor directors are confronted with the dilemma of conflicting interests and loyalties. It can be questioned whether the labor representatives' expertise is sufficient for the multifaceted functions of a supervisory board. The debate on a reduction of the directors' standard of care lingers on and is analyzed in section V of this article.

IV. Directors' Conflicts of Interest and Fiduciary Duties

A. The General Scope of Conflicts of Interest

Bearing in mind the labor participation on the supervisory board, directors performing their duties are often torn between various interests. However, all

30. Judgment of Feb. 25, 1982, BGH, 83 BGHZ 106 (the Siemens case); Judgment of Feb. 25, 1982, BGH, 83 BGHZ 144 (the Dynamit Nobel case); Judgment of Feb. 25, 1982, BGH, 83 BGHZ 151 (the Bilfinger und Berger case).

members of the board, by virtue of their appointment to this position, owe the company a duty to avoid conflict-of-interest situations.

1. *Bankers on the Board*

Such conflicts of interest can particularly arise with bank representation on the supervisory board. Under a universal banking system, like the one in Germany, that allows banks to engage in the full range of commercial and investment banking activities, bank representation on the boards of corporations is very common. The German practice of having bank delegates on the supervisory board has been regularly observed since the early nineteenth century and has had important internal and external functions. Bank representation on the board, together with other influences exercised by the banks on the corporations, has emerged as one of the decisive notions in the fast developing merger (and oligopoly) scene in the German trade, insurance, and banking industries.

Various conflicts of interest can occur for a bank's director. The director might use secret information of the corporation for other clients. Or the director might pass confidential data to the bank that results in an extension or, in the negative event, a reduction of a credit line. Also, the complex problem of multiple loyalties arises.

In particular, the problem of insider trading comes up. The U.S. reader must realize that unlike the U.S. securities laws, German law does not provide specific rules on insider trading. Therefore, a bank representative on a supervisory board may use special information and influence to initiate an acquisition of that company by one of the bank's other industrial clients. This issue has recently been discussed concerning the takeover of AEG by the car-manufacturer Daimler-Benz.[31]

2. *Directors Serving on Several Boards, Interlocking Directorates*

Representatives of banks are not the only directors who face the problem of multiple loyalties. This critical issue also appears in the case of ordinary directors serving on several boards and thus leads to the present discussion of the law of interlocking directorates in Germany and in the United States.[32] German law allows an individual to be a member of the boards of several corporations. Interlocking personnel is regarded as a legally accepted device for acquiring corporate control. German law, however, prohibits cross-membership on the management and supervisory boards of two or more corporations (section 100, subsection 2). Under generally accepted German legal opinion, the directors'

31. *See* Frankfurter Allgemeine, Dec. 3, 1985, note 280, at 13; concerning the banker's influence and depositary vote, see Vagts, *supra* note 2, at 53–58; the system of obtaining proxies is described and evaluated by Grossfeld, *Management, supra* note 2, at 1341–42; *see also* Grossfeld & Ebke, *Controlling Corporate Power, supra* note 2, at 412–15; Raiser, *supra* note 2, at 1113.

32. For further discussion of interlocking directorates, see most recently Ebke, *Interlocking Directorates*, 19 ZRG 50–106 (1990), with a detailed analysis of U.S. law; *see also* Behrens, *supra* note 2, at 15–16.

loyalty must be evenly divided between the different corporations. To this end, the director must base decisions on each board only on the interest of the respective corporation, keep each corporation's business secrets without using them for the benefit of other corporations, and devote time and energy to these corporations in proportion to the time mandated by each of them.[33] These statements highlight the variety of directors' duties as well as the standard of care in exercising them. It follows that a director is exposed to greater liability while serving on several boards due to the dilemma of multiple loyalties.

In order to limit divided loyalties and the overload of a director's work resulting from several board memberships, the law restricts the number of directorships. Under section 100, subsection 2, sentence 1, no person may sit on more than ten boards of companies that are required by law to establish a board. This limitation does not pertain to companies that have a voluntary board.

3. *No Justification of a Conflicts-of-Interest Situation*

German Court decisions and legal literature have emphasized that conflicting interests of another company where the director also serves on the board do not justify any act by the board even if that act was in furtherance of the interest of another company on which the director also serves as a board member. Fulfillment of a duty in one case does not legitimate breach of duty in the other.[34] Directors' liability appears to be a severe problem in this context. A solution cannot easily be found.

When a conflict of interest arises, the member should abstain from participating in the particular decision involving that conflict by not voting. In the case of a continuing conflict-of-interest situation, the director should resign from the board. A director who reacts differently is potentially liable for damages under sections 116 and 93. These considerations are valid in all cases where there is a board, mandatory or not, and thus for both an AG and a GmbH. These remarks also pertain to labor directors who often face a conflict of interest, in particular when a strike of the work force occurs.[35]

B. Specific Conflicts of Interest

With regard to the full range of conflicts of interest only a few of the typical conflict situations can be examined.

33. For further details concerning the issue of multiple loyalties, see M. LUTTER, *supra* note 4, at 121–28; Behrens, *supra* note 2, at 15–16.

34. Judgment of Mar. 26, 1984, Bundesgerichtshof, BGH, 29 AG 181, 185; Judgment of Dec. 21, 1979, BGH, 33 NJW 1629, 1630 (1980); Judgment of Oct. 12, 1940, Reichsgericht, RG, 165 ENTSCHEIDUNGEN DES REICHSGERICHTS IN ZIVILSACHEN [RGZ] 68, 79; A. BAUMBACH, *supra* note 2, § 111 note 4; HOFFMANN, *supra* note 7, No. 500, 501; H.J. MERTENS, *supra* note 4, § 93 note 22; *see also* M. LUTTER, *supra* note 4, at 121–28; MESTMÄCKER, VERWALTUNG, KONZERNGEWALT UND RECHT DER AKTIONÄRE 253, 254 (1958); Hopt, *supra* note 2, at 1360; Ulmer, *Aufsichtsratsmandat und Interessenkollision*, 33 NJW 1603, 1604 (1980).

35. HOFFMANN, *supra* note 7, No. 500, 501; for detail, see Hopt, *supra* note 2, at 1359–62.

1. *Personal Self-Dealing*

Personal self-dealing seems historically to be a prototype of directors' conflicts of interest and one of the earliest regulated. A conflict between corporate interest and directors' personal self-interest has always existed. The oldest, and at the same time most simple, legal approach to this conflict is the strict prohibition of any such transaction. Presently, German courts apply a broader, more sophisticated "general fairness" test. There is no outright prohibition of transactions in connection with personal self-dealing.

The courts may interfere on a case-by-case basis, and it is difficult to state sound general criteria. This concept of fairness, based on the notion of *Treu und Glauben* (good faith) in the sense of section 242 of the German Civil Code, grants judicial discretion and invites the court to do equity.[36] Furthermore, personal self-dealing of supervisory board members could incur directors' liability pursuant to sections 93 and 116. The misuse of the member's powers to the detriment of the company could also be construed as fraud and as a breach of trust and, therefore, could trigger criminal sanctions under sections 263 and 266 of the German Criminal Code.

2. *Use of Corporate Opportunity*

A director should refrain from private deals that are offered in connection with the director's function within the corporation. The company has the right to consider any offer in the line of its business and to claim all relevant business opportunities.[37] Whereas a highly developed doctrine of corporate opportunity has emerged in the United States, no such distinct doctrine exists in Germany. Directors' misuse of corporate opportunity falls into the all-embracing scheme of directors' liability based on sections 93 and 116.[38]

3. *Corporate Secrecy*

The use of corporate information represents another conflict of interest issue that is sometimes treated as part of the corporate opportunity doctrine.[39] In German jurisprudence similar results are achieved by the doctrine of corporate secrets that the director may not reveal or use for the director's own or other persons' benefit. Section 116 and section 93, subsection 1, sentence 2, express a basic director's duty to keep all company secrets in strictest confidence. This requirement can be easily understood since all board members must be ac-

36. G. WIEDEMANN, I GESELLSCHAFTSRECHT (COMPANY LAW) 346 (1980); Kübler, *Erwerbschancen und Organpflichten, Überlegungen zur Entwicklung der Lehre von den "corporate opportunities,"* in FESTSCHRIFT FUR WINFRIED WERNER, *supra* note 4, at 437, 438.

37. *See* SCHOLZ-SCHNEIDER, GMBH-GESETZ, § 43 note 144 (6th ed. 1978); Kübler, *supra* note 36 at 437, 438; MESTMÄCKER, *supra* note 34, at 166; for an American perspective, see Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 998 (1981).

38. Kübler, *supra* note 36, at 437, 446.

39. Brudney & Clark, *supra* note 37, at 1007, 1040; Hopt, *supra* note 2, at 1359–62.

quainted with all relevant matters pertaining to the management of the company.[40] Thus, the directors are provided with significant data of the corporation, including secret information. The German Legislature has realized the company's need for protection, and in section 404 it has mandated the imposition of criminal sanctions on directors who expose corporate secrets.

Apart from the problem of the exact definition of the corporate secret,[41] which is beyond the scope of this article, another issue arises with respect to where to draw the line between the company's legitimate sphere of secrecy and disclosure to the supervisory board in general, as well as to labor and to the public. A precise line can only be drawn by the courts.

In the *Bayer* case the German Supreme Court for Civil Matters dealt with several issues resulting from corporate secrecy.[42] The plaintiff in that case, a director from the labor side, challenged the supervisory board's rules on corporate secrets as illegal; in the plaintiff's view the board's rules intensified the pertinent provisions of the AktG. The Supreme Court judges allowed the plaintiff's complaint and held that the directors' duty to keep corporate secrets could not be hardened by corporate bylaws or business rules. This legal duty resulted from a subtle balance between the company's interest in keeping business secrets and the directors' need as members of an independent body of the corporation to freely express their opinion.[43]

Since labor codetermination came into effect, particularly under the Codetermination Act of 1976, one of the most important institutional conflicts of interest is corporate secrecy. The workers of the corporation, and even more so the unions, request first-hand information from the board. They want to use the data as a basis and as a device for their strategy within the corporation itself and, furthermore, on the level of the sphere in which the specific corporation is active or even within the economy as a whole. Leading German legal writers deny the validity of such requests, stating that in introducing the Codetermination Act the German Legislature did not intend to grant the unions far-reaching disclosure devices with substantial political impact.[44]

4. *Fiduciary Duties*

Directors must, by reason of their fiduciary duties, avoid possible conflicts of interest. As shown above, the supervisory board members owe several fiduciary

40. H.J. MERTENS, *supra* note 4, § 93 n.37; Schilling, *supra* note 2; § 93 note 11; for detail, see M. LUTTER, *supra* note 4, at 4; Schwark, *supra* note 4, at 841, 847.

41. *See* Claussen, *Über die Vertraulichkeit im Aufsichtsrat*, 26 AG 57, 58 (1981); *see also* HOFFMANN, *supra* note 7, No. 261; M. LUTTER, *supra* note 4, at 129, 130.

42. Judgment of June 5, 1975, Bundesgerichtshof, BGH, 64 BGHZ 323; M. LUTTER, *supra* note 4, at 121, 123–24; Schilling, *supra* note 2, § 93 note 8; Hopt, *supra* note 2, at 1361–62.

43. Judgment of June 5, 1975, Bundesgerichtshof, BGH, 64 BGHZ 327 (1975).

44. *See* M. LUTTER, *supra* note 4, at 123, 124, 187; Hopt, *supra* note 2, at 1360–62; Schwark, *supra* note 4 at 841, 847.

duties to the company. Under German corporate law these duties are called *Loyalitäts- und Treupflichten.*[45]

Pursuant to another development of German courts and jurisprudence, the directors are bound to the *Unternehmensinteresse,* that is (literally translated), the "interest of the company." The directors' duty to safeguard the *Unternehmensinteresse* has been underlined by the German Constitutional Court examining the Codetermination Act of 1976[46] and by the German Supreme Court for Civil Matters in the previously mentioned *Bayer* and *Hertie* cases.[47] Both in the *Bayer* and in the *Hertie* decisions, the Supreme Court's holdings obligate the directors to the "interest of the company." The rationale emphasizes that this expressly refers to labor directors.[48]

Parallel to the American fiduciary duty, the function of the *Unternehmensinteresse* appears to draw conclusions from the phenomenon of separation of ownership and control. The legal concept acknowledges the directors' autonomy and tries to compensate for it by the imposition of the foregoing obligations. Again, corporate governance comes into play.

It is questionable whether the previously mentioned directors' duties can literally be translated as "fiduciary" duties, in the sense of U.S. doctrine. The development of the concepts of trust and of fiduciary responsibility in Anglo-Saxon law is too different from many continental legal systems, including the German system. From a German point of view, in summary, the directors face a variety of duties resulting from different conflicts of interest. If they breach any of these duties they might be exposed to liability. Facing the multitude of directors' duties, one asks how the German law implements a legal basis of directors' liability. This question is answered in the next section.

V. Legal Basis and Standards of Directors' Liability

A. Relevant Legal Provisions

1. *Sections 93 and 116 as "Basic Norms"*

The AktG expressly provides, in section 116, for liability of the members of the board of directors. Section 116 refers to section 93, stating that this provision concerning business managers' liability also applies to directors. It thereby es-

45. M. Lutter, *supra* note 4, at 200, 211; H.J. Mertens, *supra* note 2, § 93 note 20; Kübler, *supra* note 36, at 437, 448; Schilling, *supra* note 2, § 93 note 10; Ulmer, *supra* note 34, at 1603, 1606 (1980).

46. Judgment of Mar. 1, 1979, 50 BVerfG 290, 374, 32 NJW 699 (1979).

47. Judgment of Nov. 15, 1982, Bundesgerichtshof, BGH, 85 BGHZ 293 (1983) (the Hertie case) and Judgment of June 5, 1975, Bundesgerichtshof, BGH, 64 BGHZ 324, 330 (1975) (the Bayer case); *see* M. Lutter, *supra* note 4, at 200; Claussen, *supra* note 5, at 7; Hopt, *supra* note 2, at 1361–62; Schilling, *supra* note 7, at 341, 342.

48. Judgment of Nov. 15, 1982, Bundesgerichtshof, BGH, 85 BGHZ 293, 300 (1983) and Judgment of June 5, 1975, Bundesgerichtshof, BGH, 64 BGHZ 324 (1975); Hopt, *supra* note 2, at 1361–62.

tablishes the legal basis and the standards for the performance of duties and, in the breach thereof, for liability of both executive managers and directors.[49]

The law applies a flexible standard of care and performance of duties. The standard is that of a diligent and prudent businessperson or supervisory board member. The complexity of the directors' duties has been revealed in section II, concerning the board's functions and in section IV, regarding conflicts of interest and fiduciary duties. The AktG refers to this discretionary test more often.

Section 309 and section 310 create liability for improper performance of duties by the members of a company's administration if the company is controlled by, or controls another, corporation on the basis of a "control or domination agreement." Section 317 and section 318 spell out specific duties. The breach of those duties will entail liability for the member of the administration of both the controlled and the controlling company if this control is exercised only by virtue of a majority shareholding.

The case may be different for GmbHs that are governed by the GmbHG. These companies are not required to set up a board, except under the Codetermination Act, where by virtue of size or type of business a supervisory board may be mandatory and may be subject to the relevant provisions of the AktG. If a board is established only by virtue of the company's bylaws, section 52 of the GmbHG expressly stipulates liability of directors by reference to sections 116 and 93, subsections 1 and 2, unless the bylaws provide differently, which is sometimes the case. Section 52, subsection 1, of the GmbHG does not refer to section 43 of the GmbHG, which functions as the general liability clause for the business managers of a GmbHG and applies the same flexible standard of a prudent or reasonable businessperson. Thus, according to section 52, subsection 1, of the GmbHG, in a GmbH the legal basis for directors' liability may, more often than in the case with the AG, be found in the bylaws. If, however, the GmbH comes under the Codetermination Act of 1976, and the company must form a mandatory board, then section 116 applies, in accordance with section 25, subsection 1 No. 2, of the Codetermination Act of 1976.

2. *"Groups of Companies"*

The AktG contains rather extensive norms on related enterprises or so-called "groups of companies" (sections 15 et seq. and sections 291 et seq.). Those rules, among others, cover enterprises controlled by another enterprise by virtue of a "control or domination agreement" or through a majority shareholder (domination in fact, or de facto control). Various provisions provide for a far-reaching liability of directors. The pertinent norms also apply the flexible concept of the prudent reasonable businessperson. The results of a conference on

49. HOFFMANN, *supra* note 7, No. 504; M. LUTTER, *supra* note 4, at 4; Schneider, *Haftungsmilderung für Vorstandsmitglieder und Geschäftsführer bei fehlerhafter Unternehmensleitung*, in FESTSCHRIFT FUR WINFRIED WERNER, *supra* note 4, at 795, 799.

Comparative Law Concerning "The Law of Corporations in Comparative Perspective" have recently stressed this flexible concept based on the acquisition of control.[50]

In a corporation dominated by contract the controlling enterprise obtains the right to give instructions to the board of managers concerning the management of the company. The managers of the controlled company must strictly observe any lawful instruction forthcoming from the "parent." Harmful instructions to the company are not necessarily considered unlawful as long as they serve the interest of the combined enterprise as a whole. Section 309 implements liability of the legal representatives of the controlling company, including the directors. The standard is the diligence and care that a prudent or reasonable executive should use in issuing instructions. The supervisory board of the controlling company may therefore become liable if, because of insufficient supervision, the executive managers are not prevented from issuing unlawful instructions to the controlled company. Contrary to the liability rules of sections 116 and 93, shareholders and creditors of the controlled company may assert claims for damages against the directors of the controlled company. Under section 310, the directors of the controlled company may be jointly and severally liable with those of the parent if, for example, the directors, for lack of proper supervision, fail to prevent the managers of the controlled company from following an unlawful instruction from the parent company.

In case of de facto control, the controlling enterprise may not give instructions detrimental to the controlled company unless it provides for full monetary compensation for business losses sustained due to instructions from the controlling company. If the controlling company fails to do so, it incurs liability for damages jointly and severally with its legal representatives, including the directors.[51] The most important duties of the directors of the controlled company are to review the so-called "controlled company report" and to report to the shareholders. The

50. Twelfth International Conference on Comparative Law, *see, e.g.*, Behrens, *supra* note 2, at 16–26. For a more recent example, see *Das Gesellschaftsrecht der Konzerne im internationalen Vergleich. Ein Symposium des Max-Planck-Instituts für ausländisches und internationales Privatrecht*, Conference held in Hamburg, Nov. 30–Dec. 1, 1989 (1990), including among others: Ebke, *Die Konzernierung im US-amerikanischen Recht;* Hommelhoff, *Gesellschaftsformen als Organisationselemente im Konzernaufbau;* Sonnenschein, *Der Schutz von Minderheitsgesellschaftern und Gläubigern der abhängigen Gesellschaft.* For further details concerning German law, see M. LUTTER, *supra* note 4, at 41 (duty to report within groups of companies) & 151 (duty of confidentiality within groups of companies); Lutter, *Stand und Entwicklung des Konzernrechts in Europa*, 16 ZRG 324–369 (1987); for a discussion of the problem of codetermination in groups of companies, see Hopt, *supra* note 2, at 1362–63; regarding the problem of interlocking directorates in groups of companies, see Ebke, *supra* note 32, at 103–05; from the standpoint of Comparative Law, see B. GROSSFELD, MACHT UND OHNMACHT DER RECHTSVERGLEICHUNG 67 (1984); for the perspective of an American lawyer, see Buxbaum, *Extension of Parent Company Shareholders' Rights to Participate in the Governance of Subsidiaries*, 31 AM. J. COMP. L. 11 (1983); M. EISENBERG, *supra* note 2, at 213–315.

51. AktG § 317(10), (3); for a more detailed overview, see Behrens, *supra* note 2, at 22–23; *see also* Raiser, *supra* note 2, at 119.

directors will be liable if they breach this duty with respect to damaging dealings with the controlling enterprise or with respect to instructions issued by the controlling company.[52] Once again, the discretionary standard of care of a diligent and prudent businessperson is applicable.

In the situation of controlled and controlling enterprises the directors' liability is not shifted to the controlling enterprise, although the scope of activities of the board of the controlled company, and accordingly the scope of its liability, may be somewhat restricted. It is noteworthy that the directors' exposure to liability within the broad field of the law of controlled and controlling enterprises depends on the prudent or reasonable businessperson's judgment and, therefore, how this flexible standard is construed and applied in each individual case. One can conclude the following: powers of control should be counterbalanced by respective responsibilities. The devices of acquiring control vary accordingly, as do the liabilities and duties and obligations resulting from the exertion of control. Directors' liability can also result in criminal sanctions, for example, for severe cases of fake representations and for breach of the duty of strict confidentiality regarding company secrets (sections 399, 400, 404). Because managerial control has shifted to outside entrepreneurial interest, German law, in addition to establishing liability where control is abused, focuses on the attempt to protect shareholders and creditors against risks resulting from a corporation's loss of decisional autonomy and financial integrity.[53]

B. Standards of Duty and Care

1. *Flexible Concept of a Prudent Businessperson*

The scope and broadness of liability in performing particular duties depend upon what may be reasonably demanded from directors performing such duties in light of relevant legal provisions and good business practices and customs.[54] Sections 116 and 93 also set the standards for liability of directors. Directors are responsible for performing their supervisory duties with the care of a diligent and prudent businessperson who has been appointed director. Generally, this provision not only encompasses the duties of directors that are expressly mentioned in the provisions governing directors, but also ensures the proper performance of duties not spelled out.[55]

As shown above, various norms of the AktG apply the prudent businessperson test. This broad test serves as a flexible approach in order to achieve a satisfac-

52. AktG § 318(2); as to the directors' duty to examine the "controlled company report," see M. Lutter, *supra* note 4, at 20; Behrens, *supra* note 2, at 23–24.

53. AktG §§ 399, 400, 404; for further details, see Hoffmann, *supra* note 7, Nos. 260, 507; M. Lutter, *supra* note 4, at 4, 145 & 193.

54. H.J. Mertens, *supra* note 4, § 93 note 33.

55. *See* Hoffmann, *supra* note 7, note 504; M. Lutter, *supra* note 4, at 4; H.J. Mertens, *supra* note 4, § 93 note 19; Schilling, *supra* note 2, § 93 note 9; Schneider, *supra* note 49, at 795, 799.

tory, adequate, reasonable result. Presently, the prudent or reasonable person, the modern "golden rule," appears in various fields of American and German law. The term functions as a means of evaluating the relevant legal behavior of human beings. Thus, different standards of required behavior are established, for example, the standards of a business-type situation, personified by the prudent or reasonable businessperson. It is not feasible to give a precise definition of a *bonus socius;* by the same token, it appears to be unfeasible to describe exactly the reasonable businessperson. The courts have the final say based on sound reasoning from case to case.

2. *Minimum Standard*

Generally speaking, the board members are part-time directors who work mainly in other professions. From a practical standpoint they can devote only a certain amount of time to their supervisory board duties. The law takes this situation into account; section 110, subsection 3, provides for, in general, at least two meetings of the supervisory board per calendar year.

The directors must have a general insight into management and business conditions and must also understand the interrelations between business and society. Expert knowledge regarding the company's particular line of business is not generally required. With regard to codetermination, the representation of employees on the board can only operate successfully if the unique contact these members have with the daily work of the company and their insight into its personnel policy are accepted by the shareholders' members of the supervisory board as valuable expertise.

The principle of equal treatment of all directors, with an emphasis on labor members,[56] does not allow a reduction or differentiation of the standard of care for labor representatives because of their purportedly minimal standard of expertise.[57]

Not all board members can have the general insight into business life that would be expected of those who, due to their profession, have expert knowledge. All board members, however, should have or should acquire an exposure to the fundamental structure of their particular company, as well as an elementary knowledge of the framework and organization of corporations in general. The board members should also be familiar with basic legal notions, such as corporate governance, conflicts of interest, and directors' (fiduciary) duties.

This minimum standard of directors' expertise is generally accepted among German courts and scholars. In its *Hertie* decision the German Supreme Court

56. Judgment of June 5, 1975, Bundesgerichtshof, BGH, 64 BGHZ 324, 325, 330 (1975); HANAU & ULMER, *supra* note 23, § 25, Nos. 76, 100; M. LUTTER, *supra* note 4, at 187.

57. HANAU & ULMER, *supra* note 23, § 25, No. 118; HOFFMANN, *supra* note 7, No. 104; LUTTER, *supra* note 4, at 187; H.J. MERTENS, *supra* note 4, § 11 note 25; Schwark, *supra* note 4, at 841, 842; Semler, *supra* note 7, at 141, 145.

for Civil Matters has stressed that each director must comply with certain minimum qualifications that enable the director to understand and decide on the normal course of dealings of the company.[58] Such a minimum basis of directors' qualifications contains, for example, their ability to comprehend the company's production line and annual balance sheet. The standard of care of a sensible director is tied to this basis and generally leads to reasonable solutions. Liability usually attaches only in cases of clear and unacceptable neglect of those minimum duties.

3. *Directors with Special Expertise*

Individual supervisory board members may possess a specific expertise, for example, on financial matters. In particular, the establishment and functioning of special committees has lead to an increase in the standard of care regarding expert knowledge. There is a tendency toward broader liability of directors with special qualifications or expert knowledge, such as bankers, lawyers, certified public accountants, or auditors.[59]

Due to the similarity of German and Austrian corporate law, German commentators have paid much attention to a decision of the Austrian Supreme Court. The Austrian Supreme Court has applied higher standards of bankers' duties of care in the recent *Krauland Bank* case.[60] The court examined the bankers' liability as directors of a company that had gone bankrupt. The judges pointed to the bankers' education, experience, and other qualifications and held that their legal expertise on the law of safeguarding credits in particular enabled them to understand financial and economic affairs more deeply. Thus, the bankers were exposed to broader liability. Because of the similar corporate law system, especially concerning the liability provisions, the court's holding is applicable to the German discussion on directors' liability. Several German legal writers, therefore, recommend imposing such a higher standard of directors' duties upon German supervisory board members.[61]

It is somewhat astonishing for an American reader to note that German law reporters do not contain many decided cases on directors' liability. Because there are no class actions in Germany, a large number of cases involving directors' liability, as can be found in the United States, simply does not exist. However,

58. Judgment of Nov. 15, 1982, Bundesgerichtshof, BGH, 85 BGHZ 293, 295, 296 (1983); ECKHARDT, *supra* note 4, § 116 note 10; HOFFMANN, *supra* note 7, No. 505; H.J. MERTENS, *supra* note 4, § 111 note 25; Hommelhoff, *supra* note 7 at 316, 322; Schilling, *supra* note 7, at 341, 342; Schwark, *supra* note 4 at 841, 847 & 853; Semler, *supra* note 7, at 82, 83.

59. HOFFMANN, *supra* note 7, No. 505; Schneider, *supra* note 49, at 795, 796; Ulmer, *supra* note 45.

60. Judgment of May 31, 1977, Oberster Gerichtshof (Supreme Court) OGH, Aus., 28 AG 81, 82 (1983); *see also* Hommelhoff, *supra* note 7, at 841, 843, 849, 853; Semler, *supra* note 7, at 82, 83.

61. Hommelhoff, *supra* note 7, at 315, 322; Schwark, *supra* note 4, at 841–43, 849, 853; Semler, *supra* note 7, at 82, 83.

some new decisions underline the trend towards a broader liability of "expert directors."

In a fairly new decision the Supreme Court for Civil Matters invoked the liability of the chairman of the supervisory board, who had undoubtedly breached his duties by consenting to illegal payments in favor of the company's officers and third persons.[62] In the *Beton- und Monierbau* (BuM) case the court disallowed the claim for the bankers' liability as directors of a large contractor company that went bankrupt.[63] The administrator in bankruptcy proceedings brought an action against the main creditor bank, the Westdeutsche Landesbank (WestLB). The judges did not examine in great detail whether the bank representatives actually violated their duties as directors of the supervisory board of the company that went bankrupt; even if there was a violation, the defendant bank could not be held liable for its employees' actions that allegedly occurred on another company's (i.e., BuM's) supervisory board.[64]

The Appellate Court of Düsseldorf recently affirmed the liability of a certified public accountant serving as a director on the ground that his professional expertise gave him the ability to analyze the company's financial situation.[65]

Furthermore, the District Court of Hamburg found a director liable based on his expert knowledge as a banker.[66] The judges found a breach of his duties because he influenced the company to issue a bill of exchange despite the company's critical financial state.

The standards of duty and care can be summarized as follows: The minimum standard of a "prudent director's qualification" is a flexible test under which liability is rarely imposed and, when it is, only in cases of clear neglect of duties. Supervisory boards of larger enterprises, however, typically consist of "expert directors" such as bankers, lawyers, certified public accountants, or auditors. According to various modern court decisions their expertise exposes them to broader liability.

C. Legal Prerequisites for Directors' Liability

1. *Fault and Negligence*

Apart from breach of duties as stated in sections II and IV, the basic legal prerequisites for directors' liability are fault and negligence.[67] In determining fault and negligence the courts have a substantial margin of discretion due to the

62. Judgment of Mar. 4, 1985, BGH, 30 AG 217 (1983).
63. Judgment of Mar. 26, 1984, BGH, 29 AG 181, 185 (1984).
64. *Id.*
65. Judgment of Mar. 8, 1984, Oberlandesgericht (Appellate Court) Düsseldorf, OLG, W. Ger., 29 AG 273, 274 (1984).
66. Judgment of Dec. 16, 1980, Landericht (District Court) Hamburg, LG, W. Ger., 27 AG 51, 53 (1982).
67. MEYER & LANDRUT, *supra* note 2, § 93 notes 14 & 15; ECKHARDT, *supra* note 4, § 93 note 2; H.J. MERTENS, *supra* note 4, § 93 note 12.

flexibility or, more critically, the vagueness of the terms. What constitutes fault, improper conduct, and negligence depends upon the requirements demanded by the AktG and by the courts for the directors in the exercise of their various duties. As shown above, the standard of care, the same on a minimum or expert level, must be taken into account. The standard of care and proper performance of duties is set on an objective level. Certain laxities among individual directors must be omitted as irrelevant from a legal standpoint.[68] In addition, an individual person's actual knowledge and ability to acquire knowledge must be considered.

Liability for improper performance of the duties of the board rests on the individual directors and depends upon their personal acts. In order to be held liable the individual member of the board must be in breach of duty. If more than one member of the board is in breach of duty, each member will be jointly and severally liable (sections 116 and 93, subsection 2, sentence 1).

It follows from the previously discussed topic that directors' liability contains objective and subjective elements. The objective analysis determines whether there is a breach of directors' duties, depending to a large extent on the standard of care and performance of duties. Subjective elements are taken into account on a second level, which focuses on the individual member in question, the member's personal ability, and the member's actions in the relevant case.[69] The basic liability provision, section 116, underlines this twofold approach; it contains the terms "duty of care," the objective basis, and "responsibility," the individual or subjective sphere.

2. *Burden of Proof and Money Damages*

According to section 116 and section 93, subsection 2, sentence 2, and other similar provisions, the burden of proof is on the director to show that the act with respect to which liability is asserted was not a breach of duty. This is a complete deviation from the general rule of German civil procedure that a person seeking to hold another person liable for a breach of duty must prove such a breach.[70] The same rule applies to the directors of a GmbH that has a mandatory supervisory board. If there is a voluntary board, the rule applies unless the bylaws provide to the contrary (section 52 of the GmbHG).

Directors liable in damages for breach of duty must make good the damage resulting from such breach. Under section 249 of the German Civil Code, the person liable generally owes restitution to the damaged party. With respect to directors' liability, a money payment is usually necessary. The company, repre-

68. Judgment of Mar. 8, 1984, Oberlandesgericht, Düsseldorf, OLG, W. Ger., 29 AG 273, 275 (1984); for earlier cases, see Judgment of Nov. 17, 1932, Reichtsgericht, RG, 138 RGZ 320, 325 (1932) and Judgment of Mar. 17, 1930, Reichtsgericht, RG, 128 RGZ 39, 44; *see also* HANAU, *Commentary on German Civil Code* [BGB], in MÜNCHNER KOMMENTAR § 275 note 80 (2d ed. 1985); M. LUTTER, *supra* note 4, at 193; Schwark, *supra* note 4, at 841, 844.

69. Schwark, *supra* note 4, at 841, 851.

70. H.J. MERTENS, *supra* note 4, § 93 note 48; Schilling, *supra* note 2, § 93 note 17.

sented by its business management, can bring an action against the director.[71] The corporation must prove the facts that show that damage resulted from a particular event. On the other hand, if liability arises out of a situation in which a director has exercised the duties laid down in section 93, subsection 3, which mainly refers to the duties of safeguarding the company's share capital, it is presumed that damage has occurred. Thus, the director would have to disprove this presumption.

3. *Beneficiaries of Liability Provisions*

The liability provisions in sections 116 and 93 of the AktG and section 52 of the GmbHG are aimed at the protection of the company. Consequently, in the first instance only the company may assert liability against its directors. Concurrently, the shareholders or third parties do not have a claim against the directors as long as the act in question constitutes a breach of duty covered by sections 116 and 93.[72] Only in a few cases, where liability provisions in the AktG are specifically geared to the protection of the shareholders and third parties, rather than to that of the company, may the shareholders bring a claim. Such is the case under sections 92 and 401, which impose criminal sanctions, if the directors fail to call the shareholders' meeting, because of the loss of more than half of the company's share capital. Misrepresentation of the company's economic situation is penalized in the same way by section 400, under which the shareholders may bring an action based in tort.

Creditors of the company have a special position. They may assert the company's claim against the directors in place of the company, provided they cannot recover their debts from the company.[73]

4. *Exclusion, Reduction, Settlement, and Waiver of Directors' Liability; Statute of Limitations*

The bylaws of an AG may not exclude or reduce directors' liability as provided in the AktG. Section 23, subsection 5, expressly states that the bylaws cannot exempt the mandatory provisions of the Act. Sections 93 and 116 are deemed to be compulsive law. Therefore, no exclusion or reduction of liability can be provided for by the bylaws.[74] On the other hand, the statutes may impose additional liability, except for any extension of the scope of confidentiality as

71. Bürgerliches Gesetzbuch [BGB], 18 January 1986, RGB1.195 (German Civil Code); *see* M. LUTTER, *supra* note 4, at 193.

72. HOFFMANN, *supra* note 7, note 504; Schneider, *supra* note 49, at 795, 799.

73. AktG §§ 116, 93(5), sent. 1; for further detail, see HOFFMANN, *supra* note 7, note 505; Schneider, *supra* note 49, at 795.

74. With regard to the duty of confidentiality, see Judgment of June 5, 1975, Bundesgerichtshof, BGH, 64 BGHZ 325, 326 (1975); Judgment of Mar. 8, 1984, Oberlandesgericht, Düsseldorf, OLG, W. Ger., 29 AG 273, 276 (1984); ECKHARDT, *supra* note 4, § 93 note 23; H.J. MERTENS, *supra* note 4, § 76 note 19; Schilling, *supra* note 2, § 93 note 8; Schneider, *supra* note 49, at 795, 800.

expressly prescribed by law.[75] An increase in liability is rarely made and, in most cases, the Act remains the main source for directors' liability. Furthermore, the nature of the liability provisions of sections 116 and 93 excludes the possibility of contracting out directors' liability or of contractually mitigating the standards of liability below those of the AktG.

Whether a director can escape liability if outvoted by the other directors is questionable. It would appear that a director who does not participate in the execution of the resolution held unlawful may escape such liability. In such a case, however, the board member would have to resign in order to be released from liability for the consequences of such a resolution.

The company may not invoke a director's liability, if the wrongful act is the result of a lawful resolution of the shareholders' meeting (section 93, subsection 4). This, however, cannot serve to release the board from its duty to supervise the management. Therefore, calling a meeting of the shareholders, who normally have less information relevant to the proper performance of the management, will not necessarily exclude liability of the directors.

The company may only waive or settle a claim against a director after a waiting period of three years after the claim came into existence, provided the general shareholders' meeting consents to such waiver and dissenting votes by the minority do not exceed 10 percent of the share capital of the company (section 93, subsection 4). Again, the creditors of the company have a special position. Neither the lawful vote of the shareholders' meeting nor the waiver or settlement by the company binds the creditors, who, nevertheless, may claim damages from the directors concerned. The statute of limitations on such claims is five years, running from the time the claim for damages comes into existence (section 93, subsection 6). It may be shortened by contract, but this may not serve to effect an illegal waiver.

Unless it has a mandatory supervisory board, the situation in a GmbH is somewhat different in this respect. Section 52 of the GmbHG defines duties and liabilities of directors of a voluntary board only by reference to sections 116 and 93, subsections 1 and 2. Thus, the GmbH may waive directors liability, except for a willful breach of duty, or, if it does not, may settle in whatever way it thinks fit. The statute of limitations is again five years, pursuant to section 52, subsection 2, of the GmbHG, and may be shortened.

VI. Liability Insurance

All in all, the previous discussion creates a large platform of directors' liability. Consequently, one might ask about adequate means of directors' liability insurance schemes. In European countries the board members' liability is not usually covered by liability insurance, quite contrary to the U.S. practice, the

75. AktG § 93(1) sent. 2, reiterated by the German Supreme Court for Civil Matters in the Judgment of June 5, 1975, BGH, 64 BGHZ 325, 326; *see also* ECKHARDT, *supra* note 4, § 93 note 23; HANAU & ULMER, *supra* note 23, § 25, No. 113; M. LUTTER, *supra* note 4, at 190.

so-called "Directors' and Officers' Liability Insurance" (D & O Insurance). Board liability has not been considered as a serious professional liability in line with that of lawyers, auditors, or real estate agents. Another reason why the German insurance companies do not offer insurance is that, unlike in the United States, a minority shareholder suit against a director by way of a class action is not legally possible under German law. Hence, the numerous class actions against directors of U.S. companies have not been experienced in Germany. In view of this fact, German companies do not deem it to be of vital importance to grant their directors the cover of insurance.

It is interesting for a European corporate lawyer to note that section 5j of the U.S. Model Business Corporation Act expressly grants corporations the power to purchase and maintain insurance on behalf of their directors, officers, or other agents. The German insurance industry and, in particular, the German Insurance Agency (*Bundesaufsichtsamt für das Versicherungswesen*) has taken the position that, generally speaking, it is not feasible to take over the typical risk of an entrepreneur.[76] It remains to be seen whether this strict viewpoint will gradually be revised. Presently, special insurance coverage is offered in Germany, although at relatively high premiums. German insurance companies may gradually discover the growing need and market for adequate insurance. At the time being, the insurance cover is twofold: in most cases legal expense insurance (*Rechtsschutzversicherung*) is used; third party liability insurance (*Haftpflichtversicherung*) is rarely offered.[77] This analysis leads to a distinct suggestion: enforcing higher standards of care and enlarging the scope of duties make it necessary to develop, as in the United States, a reasonably priced supervisory board liability insurance scheme.

VII. Conclusion

Under the German two-tier system, the supervisory board is a cornerstone of corporate governance. The AktG requires a supervisory board for AGs. GmbHs may voluntarily institute a board, unless the Codetermination Law imposes a duty to create a supervisory board. This article has noted the special legislation, recent court decisions, and distinguished scholars' opinions that define the duties of supervisory board members and assess what constitutes improper conduct and what is the scope of liability. The main function of the part-time directors, who often serve on several (but not more than ten) boards, is to control the business management in an effective manner. The basic legal provisions concerning directors' liability, sections 93 and 116 of the AktG, contain a variety of flexible terms and general clauses. Striking examples are the standard of care of a diligent

76. Schneider, *supra* note 49, at 795, 797, 798.

77. Chubb Market Letter, Apr. 1986, edited by Federal Chubb Insurance, Düsseldorf branch; National Union Feuerversicherungsgesellschaft, German Subsidiary of the American International Group (AIG), Information Letter: "Directors & Officers Liability Insurance (D & O)."

and prudent (reasonable) businessperson, the concept of business secrets, and conflicts of interest. The legal theories together create a great deal of judicial discretion. Thus, the open issues can only be decided by the courts through reasoning on a case-by-case basis.

The prevailing legal regime relating to the acquisition of control in corporations is founded on the notion that powers of control should be counterbalanced by respective responsibilities. Such a notion enhances use of the liability device. Liabilities imposed by German law upon controlling persons, corporations, and directors are, therefore, not entirely based on the concept of abuse of control. They represent part of an all-encompassing scheme shaped to condition the legalization of a corporation's loss of decisional autonomy and financial integrity by offering protection to its shareholders and creditors.[78] The aspects of the corporate governance and control[79] on the one hand lead to a broader scope of responsibility and, finally, to liability on the other hand.

Recent developments in German corporate law reflect a departure from past judicial reluctance to provide swift and comprehensive legal sanctions if directors breach their duties. Their duties encompass the entire scope of the corporation's business. The supervisory board of a large German company is composed of members from the shareholders and labor side, in particular, from the unions. Labor codetermination has a significant impact on directors' duties, especially concerning corporate secrets. Modern court decisions strengthen the fact that the individual board member must comply with a minimum standard of business experience and expertise. That standard also applies to labor representatives on the supervisory board. "Expert directors," in particular, bankers, lawyers, certified public accountants, and auditors,[80] are exposed to a higher standard of care. Still, the scheme of the "prudent businessperson" turns out to be a flexible device for the judges to reach an adequate decision in each individual case.

Largely because there are no class actions as in the United States, only a few German cases deal with directors' liability. Liability, therefore, is not a constant danger for a director serving on the supervisory board. Nevertheless, the following can be gathered from some recent court decisions: the trend towards an enlargement of directors' duties makes the position of a director more challenging; it also increases the directors' exposure to liability so that reasonable insurance at a reasonable price might function as a necessary "parachute."

78. Expressly laid down by the Twelfth International Conference on Comparative Law; *see* Behrens, *supra* note 2, at 25–26; *see also* Raiser, *supra* note 2, at 128–29; for further treatment regarding corporate governance, see Hopt, *supra* note 2, at 1340–42; Teubner, *supra* note 2, at 155.

79. *See* Ebke, *supra* note 32, at 104–05 (concerning "control" within the board of groups of companies and the "business judgment rule").

80. W. EBKE, WIRTSCHAFTPRÜFER UND DRITTHAFTUNG (1983) (a sound analysis of the aspects of Comparative Law); for detail, see ERLE, DER BESTÄTIGUNGSVERMERK DES ABSCHULSSPRÜFERS (1990); Hopt, *supra* note 2, at 1341–42; *see also* B. GROSSFELD, *supra* note 50, at 67; most recently, see B. GROSSFELD, BILANZRECHT (ACCOUNTING LAW) 328 (2d ed. 1990), for further reference.